

Consultation Paper

On integrating sustainability risks and factors in the UCITS Directive and AIFMD

Response of the 2° Investing Initiative

Question 1: How do you understand or how would you define the notion of “sustainability risks” for the purposes of the delegated acts adopted under the UCITS Directive and AIFMD?

Explanation: Two motivations to be clearly distinguished:

(for more detail, charts and references see the Portfolio Carbon Initiative report on “Climate Strategies and Metrics”:

https://www.unepfi.org/fileadmin/documents/climate_strategies_metrics.pdf)

- ⇒ **The carbon-risk motivation: i.e. relative to managing financial risks:** three types of potential financial risks for investors are associated with climate change: (1) physical risks to assets, (2) financial risks associated with climate mitigation policies and technological or economic trends, and (3) potential legal liabilities. There is growing evidence that the nonphysical risks, often termed “carbon asset risks,” may become material, though their timescale is unclear. Equity research analysts from Kepler- Cheuvreux, HSBC Global Research, Carbon Tracker Initiative, and Mercer, among others, are demonstrating the potential impact of the energy transition on the valuation of high-carbon companies. Climate-related investor activities may be seen as a response to these risks.
- ⇒ **The climate-friendliness motivation: i.e. relative to non-financial investment preferences of investors.** Climate change goes beyond the question of financial risk and is largely based on external pressure to contribute to the transition to a low- carbon economy. Climate change is increasingly seen as a norms-based issue among investors, and some see COP21 in Paris in 2015 as an opportunity to take a public stand. In addition, public pension investors frequently include environmental, including climate, objectives in their mandates or core missions. Investors increasingly feel public pressure through nongovernmental organizations (NGOs) like 350.org and the divestment movement, and the Asset Owner Disclosure Project (AODP).

Yet achieving the two motivations requires two independent strategies. Indicators commonly used in a carbon-risk perspective (e.g., net margins, exposure to high-cost, high-carbon capital expenditure) may not be correlated with indicators commonly associated with climate-friendliness objectives (e.g., fossil fuel reserves, fuel efficiency of cars).

Two examples demonstrate why the motivations require different approaches and metrics:

- 1) Oil & gas: Exposure to high-cost (over US\$85 per barrel of oil) projects is commonly seen as an indicator of an oil company’s exposure to carbon risks. However, this indicator is not correlated with the company’s carbon intensity (carbon content of reserves / market cap), a commonly used indicator for climate-friendliness objectives.

- 2) Automobile: The climate friendliness of car manufacturers may be measured by the average miles per gallon (mpg) of their fleet. But when assessing car manufacturers' exposure to carbon risk, financial analysts look at their ability to pass on regulatory costs (e.g. a carbon tax) to consumers. These two indicators may be negatively correlated: high margins are obtained on fuel-inefficient luxury or sport cars whereas low margins are obtained on fuel-efficient small cars.

Other resources on the question of assessing carbon related risk specifically:

2° Investing Initiative: Carbon intensity \neq Carbon risk: <http://2degrees-investing.org/wp-content/uploads/2017/04/Carbon-intensity-vs.-carbon-risk-exposure-November-2015.pdf>

And the Energy Transition Risk Assessment Toolbox: <http://et-risk.eu>

ESMA should be very clear to specify what the underlying motivation for the inclusion so ESG issues is. An inclusion of a very general non-specified ESG reference risks to create more confusion than giving a clear direction of travel.

An example from discussions we had recently with representatives from financial institutions:

Using a general formulation as suggested could be interpreted by market players as the requirement to consult retail investors if they want ESG risks to be taken into account for their investments. First of all, there is no precedent for singling out one risk factor and giving the investor a say on which risk factor(s) he/she wants to be taken into account for the overall financial risk assessment.

Second, many market players actually claim that they assess ESG-related risks already as a standard factor in their risk assessment. Giving the investor the choice to opt-out of ESG risk assessments would make all investment products they offer non suitable. Given that the overarching objective is to protect the client from financial risks (no matter what the factor is that triggers them) such an approach seems to be contrary to the objective.

That said, in general we recommend following the approach suggested by the HLEG on Sustainable Finance:

The HLEG on Sustainable Finance specifically warned against using the broad concept of integration of ESG factors/ risks but rather recommended the ESAs to mandate the extension of the time horizon of the risk analysis in line with the time horizon of beneficiaries' investments (See table on page 42 of the HLEG Final report). This would allow the risk analysis to capture all long-term, non-linear and non-cyclical risks (including any ESG related risks such as climate related risks).

Question 2: Do you agree with the proposed amendments relating to organizational requirements included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

To best reflect the call for advice of the Commission the chosen objective may vary and depend on the related articles that are to be amended:

While indeed the extract from the Commission's request for advice (mandate) seems to suggest a strong focus for a risk related objective, there is also evidence that the Commission is equally seeking to achieve climate-friendliness objectives which are linked to clearly specified targets.

The Commission Request for Advice states as the first overarching goal to:

“reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth”

The Sustainable Finance Action plan itself further specifies that the guiding principles for achieving sustainable and inclusive growth are the objectives set in the Paris agreement and the UN 2030 Agenda for Sustainable Development.

This formulation suggests that, besides the objective to manage financial risks, the Commission is also seeking to align financial flows with the Paris Agreement Climate goals and thus actively reorient financial flows to economic activities that are aligned. The same logic is applied to the SDGs.

A recent discussion on practical approaches to the objective to reorient capital flows:

ISS/2° Investing Initiative: Climate impact – what it is and how to achieve it: https://2degrees-investing.org/wp-content/uploads/2019/02/Final-draft_Climate-actions-impact.pdf

How is this related to retail investors?

Various surveys on retail clients' preferences clearly indicate that a large majority of them want their money to be used to generate environmental and social benefits. When asked about their motivation and expected outcomes, they answer that they want their influence as investors to be used to change the decisions in the real economy to deliver those outcomes. This seems to be aligned with the second objective to reorient capital flows towards sustainable investments as defined by the commission.

For the above-mentioned surveys please see for example:

- MorganStanley: Sustainable Signals
https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf

- Natixis: Mind Shift
<https://www.im.natixis.com/us/resources/mind-shift-getting-past-the-screens-of-responsible-investing>
- Bauer et al. (2018): Get real! Individuals Prefer More Sustainable Investments
<https://sustainable-finance.nl/upload/researches/Bauer-Ruof-Smeets-2018-Get-real.pdf>
- yet unpublished results of a 2° Investing Initiative survey of German retail investors:
<https://www.dropbox.com/s/c5bcmi3j63a7n24/Results%20Survey%20German%20Retail%20Investors.pdf?dl=0>).

It thus needs to be clear that any approach related to assessing and including the clients' preferences need to be strictly limited to their non-financial investment preferences, including the motivation to reorient capital flows to sustainable investments. Given the large prevalence of non-financial objectives according to the surveys cited above, it seems to be important for the objective of consumer protection and more specifically to avoid mis-selling, to ensure that the formulations used leave no doubt that such consumer preferences are expected to be identified and addressed by financial advisers.

The current wording seems to suggest a mix of motivations and does not clearly specify where which motivation is relevant. We therefore recommend reviewing the formulations and making explicit if the motivation behind the new requirements are an integration of financial risks or the taking into account of the clients' non-financial preferences with regard to sustainability. We have developed concrete suggestions for wording related to the consultation on MiFID II, which can help to inspire also the wording in relation to this consultation.

Based on the arguments outlined in Q1, for the integration of sustainability related financial risks we recommend a formulation that follows the HLEG recommendations and requires the extension of the time horizon of the risk analysis in line with the time horizon of beneficiaries' investments, in order to capture all long-term, non-linear and non-cyclical risks (including any ESG related risks).

Question 6: Do you see merit in further elaborating in the provisions above on the identification and ongoing monitoring of sustainability risks, factors and indicators that are material for the financial return of investments?

Based on the arguments outlined in Q1, for the integration of sustainability related financial risks we recommend a formulation that follows the HLEG recommendations and requires the extension of the time horizon of the risk analysis in line with the time horizon of beneficiaries' investments, in order to capture all long-term, non-linear and non-cyclical risks (including any ESG related risks).

Question 7: Do you agree with the proposed inclusion of recitals relating to conflicts of interest? Should the technical advice cover specific examples? If so, what would be specific examples of conflicts of interests that might arise in relation to the integration of sustainability risks and factors and should be covered in the advice?

Various surveys on retail clients' preferences clearly indicate that a large majority of them want their money to be used to generate environmental and social benefits. When asked about their motivation and expected outcomes, they answer that they want their influence as investors to be used to change the decisions in the real economy to deliver those outcomes. This seems to be aligned with the objective to reorient capital flows towards sustainable investments as defined in Q1.

For the above-mentioned surveys please see:

- MorganStanley: Sustainable Signals
https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf
- Natixis: Mind Shift
<https://www.im.natixis.com/us/resources/mind-shift-getting-past-the-screens-of-responsible-investing>
- Bauer et al. (2018): Get real! Individuals Prefer More Sustainable Investments
<https://sustainable-finance.nl/upload/researches/Bauer-Ruof-Smeets-2018-Get-real.pdf>
- yet unpublished results of a 2° Investing Initiative survey of German retail investors:
<https://www.dropbox.com/s/c5bcmi3j63a7n24/Results%20Survey%20German%20Retail%20Investors.pdf?dl=0>

Most ESG products are not associated with “sustainability impacts”. As noted by the HLEG Final Report (p. 10), most ESG-related products on the market today have not been designed with the objective of influencing the decisions of players in the real economy (e.g. request investee companies to align their investment plans with climate goals). They are primarily designed to marginally integrate financial risks related to ESG factors, by reducing the exposure to risky activities and increasing the exposure to green activities (e.g. green funds, low carbon ETFs, etc.). However, as discussed in Q1 these two

motivations are fundamentally different, and most investment strategies developed to mitigate ESG-related risks are ineffective when it comes to triggering changes in the real economy.

As a result, there is a fundamental mismatch between the current offer of ESG products on the market, and the non-financial investment objectives of retail investors, as revealed by various surveys. In other words: most existing ESG products would not pass the suitability test if the questions were correctly framed. A new generation of 'sustainable impact investment' products, including insurance undertakings, will need to be developed.

The most likely conflict of interest will hence be that financial institutions providing financial advice will advocate for a vague framing of any new obligation such as 'integration of ESG factors', in order to be able to sell existing ESG products despite their unsuitability, and benefit from the rent created by the regulation without having to adapt their processes.

That is one of the reasons, why we advocate to clearly define the motivation from the start. If the definitions are clear, then the metrics can follow. The effectiveness of a new recital on the topic, however, is unclear, specifically if it included wording that is not clearly defined (see also our discussion of potential misunderstanding created in Q1).

Recommendation:

Key to avoiding this conflict of interest will be the provision of clear guidance on how to assess the non-financial preferences of retail clients in the framework of the suitability assessment. As ultimately the client is supposed to define the level of ambition with regard to the objective.

In order to provide a basis for discussion, we have been setting up a stakeholder working group in Germany to discuss potential approaches for a best practice questionnaire to assess client objectives with regard to their ESG preferences in the framework of the suitability assessment. The working group comprises the German regulator BaFin (observer), the German Government (Environment Ministry), as well as several representatives from financial institutions, NGOs and Universities. We are also planning to extend the exercise to France and the European level with dedicated working groups. We are happy to share the current state of discussions with ESMA staff and would be very happy to welcome ESMA representatives to our French/European working group from the start.

In general, we believe that it would be beneficial for ESMA to commission its own research in collaboration with universities to ensure an independent understanding of client's needs and preferences. This would enable ESMA to design evidence-based requirements that limit conflict of interest and to cross-check financial institutions arguments against its own research results.